

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:CHI:M:TL-N-4891-01

date: August 13, 2001

to: Compliance Division  
Attn: Daniel K. Hammer, Senior Team Coordinator

from: Associate Area Counsel (LMSB), Chicago

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subject: [REDACTED]  
Effect of Form 870-AD, [REDACTED]

This memorandum responds to your request for assistance dated August 8, 2001, in which you ask whether a properly executed Form 870-AD bars the taxpayer from filing a claim for refund for the year covered therein. In our opinion, the form does not bar the claim, but the Service may counterclaim up to the amount of the claim.

We do not believe that this memorandum concerns an issue that requires coordination with an industry counsel.

This memorandum should not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

**Facts**

The [REDACTED] ("the taxpayer") is currently being examined by the Internal Revenue Service for the years [REDACTED] and [REDACTED]. During the course of this examination, it has come to light that tax depreciation on the taxpayer's oil and gas investments had not been claimed in the returns for any year after [REDACTED]. The Service intends to allow the depreciation deduction for [REDACTED].

The taxpayer intends to file claims for refund based on the depreciation deduction for those years prior to [REDACTED] in which the statute of limitations remains open. All of those years were closed by the Appeals Office using Forms 870-AD. The taxpayer's

failure to claim a deduction for oil and gas depreciation was an issue not known to either party during the Appeals Office consideration of those years and, consequently, was not taken into account during their negotiations in any way.

Apparently, the taxpayer's failure to claim the depreciation resulted from a mistake by the taxpayer when ACRS (accelerated cost recovery system) was converted to MACRS (modified accelerated cost recovery system). The taxpayer's investment department misinterpreted the change and the deduction dropped out of the tax workpapers. The error was discovered almost by chance in the examination of the recent cycle.

Form 870-AD is entitled "Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment." It states, in part: "No claim for refund or credit will be filed or prosecuted by the taxpayer for the years stated on this form, other than for amounts attributed to carrybacks provided by law."

#### Issue

Can the taxpayer file an administrative claim for refund and (if denied) pursue a suit for refund for a tax year in which the taxpayer executed a Form 870-AD which explicitly states that the taxpayer shall not claim a refund?

#### Law

I.R.C. § 6213(a) provides, in general, that an assessment of tax deficiency cannot be made until 90 days after a notice of deficiency is issued or, if a Tax Court petition is filed, until after the decision of the Tax Court has become final.

I.R.C. § 6213(d), however, states:

The taxpayer shall at any time (whether or not a notice of deficiency has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the assessment and collection of the whole or any part of the deficiency.

I.R.C. § 6511(a) states:

Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within three years from the time the return was filed, or two years from the time the tax was paid, whichever of such periods expires the later

I.R.C. § 7121 is entitled "Closing Agreements." It states:

The Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person . . . in respect of any internal revenue tax for any taxable period.

### Analysis

Form 870-AD presents the unusual situation of a formal, legal agreement containing an explicit, easily understood provision which, in fact, is void and unenforceable.

On its face, a Form 870-AD appears to be a mutually-agreed contract. The taxpayer gives up the right to litigate its dispute in Tax Court, the government gives up part of the deficiency it claimed, and both consent to the assessment and collection of a specified amount of tax. To ensure that the taxpayer will not evade this agreement by paying the assessment and litigating some of the settled issues in the District Court, the agreement also specifies that the taxpayer will not file a claim for refund. The agreement, however, is illusory. In a long line of cases going back to Botany Worsted Mills v. United States, 278 U.S. 282 (1929), the courts have ruled that the taxpayer's agreement in a Form 870 not to seek a refund is unenforceable.<sup>1</sup> The courts have reasoned that I.R.C. § 7121 provides the exclusive authority for closing agreements, whereby a dispute between the taxpayer and the government can be finally and irrevocably determined.<sup>2</sup> Form 870-AD is not a closing agreement within the meaning of § 7121 because it is not executed by the proper government authorities specified in that Code section.

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<sup>1</sup> "In the world of fast food chicken, 'parts is parts;' but in the world of tax settlements 'promises are not promises.'" Combs v. United States, 790 F.Supp. 850, 852 (SD Ind. 1992).

<sup>2</sup> "When a statute limits a thing to be done to a particular mode, it includes the negative of any other mode." General Split Corp. v. United States, 500 F.2d 998, 1002 (7<sup>th</sup> Cir. 1974).

It follows that the taxpayer cannot give up his right to sue for a refund by executing a Form 870-AD, even if the form explicitly contains such a provision.

The courts, however, have not been entirely unsympathetic to the plea that taxpayers are taking advantage of the government's trusting nature. Two ameliorative theories have been employed by the courts: The doctrine of equitable estoppel and the doctrine of recoupment.

The doctrine of equitable estoppel holds that, although the taxpayer's agreement in a Form 870-AD not to claim a refund is not binding under the Code, it becomes binding due to the government's reliance on it to its detriment. See Flynn v. United States, 786 F.2d 586 (3d Cir. 1986); Stair v. United States, 516 F.2d 560 (2d Cir. 1975); Daugette v. Patterson, 250 F.2d 753 (5<sup>th</sup> Cir. 1957); Cain v. United States, 255 F.2d 193 (8<sup>th</sup> Cir. 1958). There are four elements to equitable estoppel: (1) There must be a false representation or wrongful silence by the taxpayer; (2) The error must originate in the taxpayer's statement of fact, not law; (3) The government must be ignorant of the true facts; and (4) The government must be adversely affected by the acts or statements of the taxpayer. Combs v. United States, 790 F.Supp. 850 (SD Ind. 1992).

According to some authorities, the government is considered to have relied on the taxpayer's false statement to its detriment when the settlement involves a compromise of more than one disputed issue, a Form 870-AD (containing a promise not to seek a refund) is executed, and the statute of limitations on assessment subsequently expires. See Daugette v. Patterson, 250 F.2d 753 (5<sup>th</sup> Cir. 1957).

Other courts, however, have explicitly rejected the doctrine of equitable estoppel as given above, holding that the necessary "reliance" by the government occurs only if the government relies on some false representation of fact made by the taxpayer other than the promise not to claim a refund contained in the Form 870. Lignos v. United States, 439 F.2d 1365 (2d Cir. 1971); Whitney v. United States, 826 F.2d 896 (9<sup>th</sup> Cir. 1987); Uinta Livestock Corp. v. United States, 355 F.2d 761 (10<sup>th</sup> Cir. 1966); Bennett v. United States, 231 F.2d 465 (7<sup>th</sup> Cir. 1956). The mere fact that the taxpayer has agreed in the Form 870 not to seek a refund (while intending to do so) is not considered a false representation of the kind upon which equitable estoppel can be based, because the government knows (or ought to know) that a taxpayer can give up the right to claim a refund only by executing a

closing agreement as authorized by I.R.C. § 7121. Under these circumstances, the government knows the "true facts" and therefore could not have reasonably relied on the taxpayer's promise not to sue. Bennett v. United States, 231 F.2d 465 (7<sup>th</sup> Cir. 1956). As one court put it, "the doctrine of equitable estoppel is not applicable when the sole action of the taxpayer is signing the settlement form" without any other material misrepresentations of fact. Speciality Leather Goods Co., Inc. v. United States, 64-2 USTC ¶ 9656, 14 AFTR2d 5304 (SDNY 1964).

The Seventh Circuit (which includes the State of Wisconsin) announced its adherence to this sterner standard in Bennett v. United States, 231 F.2d 465 (7<sup>th</sup> Cir. 1956). The Court later modified this position slightly, holding that equitable estoppel may exist when, due to the expiration of the statute of limitations and the "integrated nature" of a settlement involving more than one taxpayer, "there was no equitable way to undo the portion of the settlement reflected in Form 870-AD." General Split Corp. v. United States, 500 F.2d 998, 1004 (7<sup>th</sup> Cir. 1974). This relaxation does not apply, however, if there is only one taxpayer involved in the agreement. Combs v. United States, 790 F.Supp. 850 (SD Ind. 1992); Matter of Avildsen Tools and Machine Inc., 794 F.2d 1248 (7<sup>th</sup> Cir. 1986).

Even if equitable estoppel does not apply, however, relief may be allowed under the doctrine of recoupment. This doctrine holds that when the taxpayer brings a refund suit, the government can counterclaim up to the amount claimed by the taxpayer. The courts have allowed such counterclaims even if based upon issues unrelated to the issues raised in the refund claim. Speciality Leather Goods Co., Inc. v. United States, 64-2 USTC ¶ 9656, 14 AFTR2d 5304 (SDNY 1964); Bank of New York v. United States, 170 F.2d 20 (3d Cir. 1948). The only limitation on the government under this doctrine is on the amount of the government's counterclaim, not on the issues upon which the counterclaim is based. Bull v. United States, 295 U.S. 247 (1935); Lewis v. Reynolds, 284 U.S. 281 (1932).

Because your taxpayer is headquartered within the Seventh Circuit, the promise not to claim a refund (contained in the Form 870-AD) cannot in itself be the "false statement" upon which estoppel is based, and the taxpayer does not appear to have made any other false statement. At the time the Form 870-AD was negotiated, the depreciation issue was unknown to the Examination Division, the Appeals Office, and the taxpayer. The taxpayer did not make a false representation of fact (or maintain a "wrongful silence") in connection with this issue. There having been no false representation, it follows that the government did not rely on such a representation. The depreciation issue being unknown

to either party, it could not have been a condition of the settlement that the taxpayer surrender that issue in return for other concessions by the government. Under these circumstances, the government cannot claim that it relied on the taxpayer's representations to its detriment.

It should also be noted that simple justice seems to support the taxpayer's argument that it should be allowed to seek a refund (within the limits provided by the statute of limitations) based on a legitimate deduction that it neglected to claim solely due to a bookkeeping error.

It is equally clear, however, that the recoupment doctrine applies. If the taxpayer wishes to claim a refund based on the oil and gas depreciation item, the government may, at its option, counterclaim up to that amount based on any other issue.

We note that you have not requested advice as to which years (if any) are barred by the statute of limitations, and we do not give any advice on that issue in this memorandum.

Of course, this advice depends on the facts which you have presented and we caution you not to apply this advice to other taxpayers. If you have any questions or need further advice, please contact J. Paul Knap at 414-297-4246.

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By: \_\_\_\_\_  
J. PAUL KNAP  
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